

## **Appendix 3**

### **Pension and Other Social Security Obligations**

How much are Beijing's unfunded pension and other social security obligations? The best answer is that nobody knows, not even the technocrats in Beijing. "China seems to have an economy bursting with 'black holes,' " writes Simon Pritchard, *South China Morning Post* columnist.<sup>1</sup> As the world has learned by now, the extent of these unfunded obligations are one of them.

Let's start with what is known. Many workers today are entitled to pensions and other benefits, but they only have a claim against their "work unit," the term for "employer" in the Chinese Communist dictionary. As a result, some do not receive anything because their work units are insolvent or no longer functioning.<sup>2</sup> Beijing is trying to remedy the problem, and in the process build a more modern economy, by transferring pension and social security obligations from enterprises to the state. During the last decade the central government has been slowly putting into place a nationwide system for workers (peasants, some 900 million of them, are excluded). State media tells us that the structure is in place, but that's true only in the most general sense. Today, the status of the system is more than a bit confusing.

Essentially the country is in a "pay as you go" mode, making pension and other social security payments from current income. There are notional accounts for individual workers, but they are not funded. Current retirees are paid from contributions from current employees.<sup>3</sup> Today, the central and even some local governments are bailing out bankrupt local pension pools.<sup>4</sup> **Beijing has allocated US\$13.3 billion in the past three years to fund pensions and subsidies for laid-off workers.**<sup>5</sup> In 2001 the central government chipped in US\$3.7 billion.<sup>6</sup> This year it has budgeted another US\$6.2 billion.<sup>7</sup>

Although the central government underplays the dimensions of the problems, it nonetheless admits that the funding deficit is increasing at a fast clip.<sup>8</sup> Because the current system is not financially "sustainable," it has become clear that "non-reform is not an option."<sup>9</sup> Some analysts use harsher language: "China's pay-as-you-go pension system, created in 1995, is on the verge of bankruptcy,"<sup>10</sup> says consulting firm McKinsey. Problems plague the plan: solvent employers do not pay, officials embezzle, and employees are being laid off. It is reform already off the rails.

To get things back on track, last year the central government opted to test its concepts in a three-year experiment in Liaoning Province. In the words of Finance Minister Xiang Huaicheng, **"Liaoning and other provinces are prudently promoting**

**experimentation with the reform to improve the social security system.”<sup>11</sup>** These bland words underplay the significance of the experiment in the heart of China’s rust belt. If the technocrats can get it right here, the hardest place in the country to implement their ideas, they can make the social security system work anywhere. Once they get the plan to work everywhere, China will probably be able to solve its massive state-owned enterprise problem. Officials will not have to worry about social unrest as they go about restructuring the state sector.

And how is the Liaoning experiment doing these days? Just fine if you listen to senior officials. **“The trials to improve the social security system in Liaoning and other provinces proceeded smoothly,”** says Zeng Peiyan as he delivered his work report to the National People’s Congress this March.<sup>12</sup> The minister in charge of the powerful State Development Planning Commission should know what he is talking about.

Maybe he does, but almost everyone in the world disagrees with this senior official’s assessment. Among the not so optimistic is the governor of Liaoning Province, Bo Xilai. Bo, after the first year of the experiment, admitted this March that the plan is faltering.<sup>13</sup> Maybe the central government chose to conduct the experiment in Liaoning because he is “widely regarded as a masterful administrator.”<sup>14</sup> Even if the governor is the best administrator in the world or even in world history, he will be hard pressed to make the central government’s plan work.

For one thing, Liaoning is struggling to find the money to fund its financial obligations. The province paid less than one-twelfth of the pensions that it should have (Rmb1.6 billion instead of Rmb20 billion). Most employers failed to meet their required contributions.<sup>15</sup> “The scheme is grossly underfunded,” said the influential *South China Morning Post*.<sup>16</sup> “The pressure on Mr. Bo is awesome.”

Beijing officials, taking a long view, say that the funding deficiencies are manageable because the central government can make up the shortfalls with payments out of current revenues and that eventually employer and employee contributions will solve the problem.<sup>17</sup> That sounds reasonable as a general matter. Moreover, statistics produced in China do not frighten. **They tell us that the deficit in the system for the current five-year plan will be US\$35.4 billion and the total cost for the clean-up will be between US\$122 to 244 billion.**<sup>18</sup>

Those numbers, though they may sound large, are well off the mark. A better assessment comes from a World Bank expert, who estimates that in 2000 the implicit social security debt was about 71 percent of GDP.<sup>19</sup> Bank of China International, Bank of China’s investment banking operation, estimates unfunded obligations are about US\$850 billion.<sup>20</sup> As large as that figure sounds, Bank of China’s analysts may have underestimated the dimensions of the problem. There exist even higher estimates. A number often used is US\$1 trillion,<sup>21</sup> which is almost equal to current claimed GDP. Private estimates of one multilateral institution say that the cost could be as high as 100 to 125 percent of GDP.<sup>22</sup>

What is the true figure? In the middle of the last decade observers widely quoted a World Bank study concluding that funding arrears were in the neighborhood of half of GDP.<sup>23</sup> Since then, the problem has either grown worse or perceptions have become darker as experts rethink their views. Estimates of social security liabilities resemble that of analyses of nonperforming loans in the state banks: as time passes analysts come up with bigger and bigger numbers. **Although no one knows for sure, we should assume that** unfunded obligations (pensions, unemployment insurance, guaranteed living allowances, etc.) are no less than US\$1 trillion. The most important reason for adopting a number at the higher end of the range is the upcoming wave of layoffs in the state sector. Almost all commentators have, in the view of this report, underestimated the effect that accession to the World Trade Organization will have on state-owned enterprises.

Today, after Daqing and Liaoyang, the central government talks about the **jobs situation as “grim.”**<sup>24</sup> The arithmetic of Wang Dongjin, vice-minister of Labor and Social Security, is depressing. At current growth rates, the country can generate eight million urban jobs he says. Now, however, there is an “unprecedented” number of new entrants to the workforce: 12 to 13 million a year. Add in the number of five million laid-off from state enterprises and the 6.8 million registered jobless, and there is a gap of large proportions. And this situation is not helped by the army of 150 million peasants roaming the country for work.<sup>25</sup> As big as these numbers are, they do not measure unemployment in the countryside. State media tells us that the state has made “remarkable progress” in creating employment,<sup>26</sup> but that only underscores how much more remarkable its efforts must be in the future.

The situation is probably worse than Wang Dongjin lets on because he is using official numbers showing urban unemployment at 3.6 percent<sup>27</sup> while unofficial estimates go as high as 30 percent.<sup>28</sup> As the economy slows and as WTO forces wrenching changes in the labor market, the numbers of unemployed can only swell. Moreover, Wang tells us that many of those who have lost their jobs do not have the skills needed in today’s China. The implication is that they will never find steady work again. Beijing has just published a white paper that pledges to keep unemployment low,<sup>29</sup> but there are few specifics offered to achieve that goal. Even if officials get it right this time, it will take time for their policies to have effect.

Although a trillion dollars may seem like a large figure, the cost of the government’s programs, which are broad in scope, will rise above today’s projections. The white paper reminds us how broad they are by listing all the programs and especially the “two guarantees” adopted in 1998: a guarantee of basic livelihood of “laid-offs” and a guarantee of pensions for retirees. In practice, the first guarantee boils down to three policies: initial living allowances for up to three years, unemployment insurance for up to two years, and a minimum living allowance for all urban residents.<sup>30</sup> That’s ambitious and expensive, especially because not all eligible employees are receiving their “guaranteed” payments.

The total amount of social security obligations is large, but the central government still

has some time to figure out what to do--many of the pensions and other benefits will not have to be paid until far into the future. So today Beijing can cope. As Finance Minister Xiang Huaicheng says, "There is a rough balance between social welfare contributions and expenditure but a disparity from one region to another."<sup>31</sup> Yet the real problem is not what the central government would have to shell out today--it is the trend of events. Some foreign experts believe that the amount of unfunded obligations could double in two decades if implementation fails.<sup>32</sup>

Now that the system is being put into place, crafty state enterprises are taking advantage of the situation as much as they can. To lighten their payrolls, these firms are encouraging early retirement to employees, some as young as 29. Shedding young employees helps those firms, but burdens the national system.<sup>33</sup>

The real problem is not clever manipulation of state programs, however. It is demographics. **In China it is called the "silver tide,"<sup>34</sup> the wave of elderly, that poses one of the most important long-term challenges to the central government.** The People's Republic has an aging crisis as a result of population engineering--the one-child policy. As Simon Pritchard points out, other nations like Japan may be older, but China is poorer and aging faster.<sup>35</sup>

Bank of China International estimates that 22 percent of the population in 2030 will be over 60, compared with about 10 percent today.<sup>36</sup> That 10 percent today translates into 132 million people. In 1997 there were about 80 people on pensions for every 100 children below the age of five. By 2025 the number of the pensioners will balloon to 250 for every hundred kids. China's birth rate has already fallen below the replacement rate of 2.1 (it's now about 1.8). With a gender imbalance favoring males, birth rates will decline faster than the replacement rate suggests.

**So one child will not only have to take care of elderly parents, but perhaps grandparents as well. No matter how filial a son or daughter may be, the state will ultimately have to take responsibility for the old. The state is now planning to spend US\$483 million over the next three years for facilities for the aged.<sup>37</sup> That amount is just a drop in the bucket with what must ultimately be spent.**

Beijing is running out of options.<sup>38</sup> Economic growth could alleviate the stress of unfunded obligations, but if it's not evenly distributed it may not help much. Taking more money from the workers is not under discussion. Their contributions are already a sky-high 20 to 30 percent of salary. Technocrats can make the problem look better by adjusting the simple things like the discount rate, but that's just cosmetics. Some have suggested decreasing benefits to make the system solvent. But, as a political matter, that is unlikely to work in a workers' paradise.

The central government had better perfect the social security system soon because the proletariat is not about to wait another five decades. Governor Bo is reported to have said this March that, despite all the unemployment and the severance of *xiagang* workers from state enterprises, society had remained stable.<sup>39</sup> Events during the rest of the month proved him wrong, however, as his Liaoning Province experienced the worst worker

unrest in recent memory, maybe even since the founding of the People's Republic. Some 30,000 to 40,000 workers protested in the city of Liaoyang over unpaid pensions and other grievances.<sup>40</sup> The massive demonstrations in Bo's province and in nearby Heilongjiang shows the truth of the following assessment from Simon Pritchard: "Pensions--or the lack of them--are the soft underbelly of reform as Beijing jettisons cradle-to-grave socialism in favour of 'user-pays' capitalism."<sup>41</sup> **If anything**, benefits in the future must go up, not down if the People's Republic is to have a tomorrow. Increasing payouts will put even more stress on the system.

**As explained in this report, the central government could fund its array of promised payments if it pushed forward with its program to sell shares of the state-owned enterprises on the domestic equity markets. Despite efforts to implement its plan this year and last, it has failed to make any progress. Stock investors have resisted the sell-down because it means that stock prices will fall as state-held shares flood the exchanges. "The problem is that the voice of laid-off workers is not heard at the decision-making levels, but retail investors in the A-share market make a big noise when the government tries to sell its stock," says Shawn Xu, an economist at China International Investment Corp. "That's why we see a slowdown on the decision to sell state shares."**<sup>42</sup>

**While Beijing figures out what to do next, the funds in the system are running down fast. In the beginning of this year Lehman Brothers estimated that social security fund assets were in the neighborhood of US\$15 billion.<sup>43</sup> Today, those assets are about US\$7.0 billion.<sup>44</sup>**

**So now we know there are many reasons why workers will have to wait for their pensions and other payments. In the meantime, they will just have to sacrifice more for the Motherland. Maybe that's why Liaoning Province, which cannot afford its social security program, does have nearly Rmb85 million (about US\$10.3 million) to spend on the renovation and expansion of the memorial to Lei Feng, the revolutionary hero epitomizing the ideal of selflessness in the People's Republic.<sup>45</sup>**

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<sup>1</sup> "an economy bursting with 'black holes' ": Simon Pritchard, "Never Too Old for Another Revolution," *South China Morning Post*, June 27, 2001, Analysis, p. 14.

<sup>2</sup> some do not receive anything because their work units are insolvent: See Mark O'Neill, "Early Retirement Swells China Pension-Fund Deficit to \$33b," *South*

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*China Morning Post*, June 25, 2001, Business Post p. 1.

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- <sup>4</sup> bailing out: Yan Wang, "China's Implicit Pension Debt and Financing Options," October 19, 2001 (paper prepared for CCER-Cato Institute Conference on China's Pension System: Crisis and Challenge, Beijing, November 8-9, 2001).
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- <sup>7</sup> US\$6.2 billion: **"Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.**
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- <sup>11</sup> **"Liaoning and other provinces are prudently promoting experimentation": "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.**
- <sup>12</sup> **"proceeded smoothly": "Full Text of Report on Development Plan by Zeng Peiyan (I)," People's Daily Online, March 17, 2002.**
- <sup>13</sup> the plan is faltering: See Pamela Pun, "Cash Shortfall Hits Pilot Pension Plan," *hk-imail.com*, March 11, 2002.
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- <sup>15</sup> Most employers failed: Pamela Pun, "Cash Shortfall Hits Pilot Pension Plan," *hk-imail.com*, March 11, 2002.

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- <sup>17</sup> Beijing officials: Mark O’Neill, “Early Retirement Swells China Pension-Fund Deficit to \$33b,” *South China Morning Post*, June 25, 2001, Business Post p. 1.
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- <sup>35</sup> China is poorer and aging faster: Simon Pritchard, “Never Too Old for Another Revolution,” *South China Morning Post*, June 27, 2001, Analysis, p. 14.
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